

TEACHERS' RETIREMENT BOARD  
INVESTMENT COMMITTEE

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Subject:	Credit Enhancement Program- Consortium Financial Group	Item Number:	<u>9</u>
		Attachment(s)	<u>2</u>
Action:	<u>X</u>	Date of Meeting:	<u>October 13, 1999</u>
Information:	<u></u>	Presenters:	<u>Mr. Heckman</u> <u>Mr. Greenlee</u>

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**EXECUTIVE SUMMARY**

One of the objectives for the Investment Branch is to “Explore, evaluate, and report on the viability of working with a consortium of public pension funds to provide credit enhancement on a national basis.” This objective provides Canadian Imperial Bank of Commerce (CIBC) with the opportunity to present the Consortium Financial Group (CFG). CFG is designed to be a credit enhancement vehicle in which a group of at least three (3) public funds would provide a committed amount of credit enhancement support to total at least \$2.5 - \$3.0 billion. CFG would be responsible for originating and servicing credit enhancement transactions on a national basis. Participating pension funds would provide up front commitments. Fees and portfolio liabilities would be divided on a pro-rata basis among public pension fund participants. Projected income and outstanding commitments from CFG are as follows:

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Total Portfolio Bil	\$2.6 Bil	\$4.8 Bil	\$7.7 Bil	\$9.9 Bil	\$12.1
Fee Income Mil	\$8.4 Mil	\$15.5 Mil	\$25.2 Mil	\$31.8 Mil	\$38.2

Some features of the program design include, but are not limited to:

- 1) CIBC, as Service Agent, will act as a fiduciary with respect to each member Fund;
- 2) CalSTRS will consider \$1 billion for its initial commitment to CFG, on a several, not joint basis.
- 3) The Program will include an opt out provision which will allow CalSTRS to be excluded from any transaction at our discretion;
- 4) Establishment of a first loss insurance policy of at least \$20 million (may be negotiated to a higher amount) by a AAA bond insurer to be provided by and paid for by CIBC;

- 5) For each credit facility issued, CIBC will enter into a Participation Agreement for 3% of the underlying transaction;
- 6) CIBC will negotiate the transfer of approximately \$1.5 billion of its current portfolio to charter members to make the endeavor a money making enterprise from the start.
- 7) The Program is designed to provide credit enhancement on a nationwide basis. Every effort will be made to ensure that CFG compliments and strengthens the existing CalSTRS Credit Enhancement Program.
- 8) The legal structure of the Program will allow CalSTRS and other Members to cancel their participation in CFG on a year-to-year basis.

Attachment 1 provides a brief history of the CalSTRS Credit Enhancement Program, the Current Credit Enhancement Market Environment, and lists other features of CFG program. In addition, Staff has provided Exhibits A through E as supporting documentation of the CFG program.

## **RECOMENDATION**

Staff recommends approval of the resolution included in Attachment 2. The resolution approves the concept of an externally managed national credit enhancement program that will serve to complement the existing internally managed Credit Enhancement Program. The resolution directs CalSTRS Staff to continue discussions regarding Consortium Financial Group (CFG) business and legal issues. Staff will provide specific investment recommendations regarding CFG at a future Investment Committee meeting.

## **CREDIT ENHANCEMENT ENVIRONMENT**

### **Background –CalSTRS Credit Enhancement Program**

CalSTRS began to develop the Credit Enhancement Program in 1991. The original intent in the research was to explore whether CalSTRS could generate fee income for the fund by assisting construction finance efforts for California public schools. It was determined that restrictions in the California Education Code prohibited such transactions at the time. From the research, however, it was considered appropriate for CalSTRS to generate fee income as a credit enhancer for public and private activity bonds in the State of California.

The original five year objective was to have \$1 billion in outstanding commitments (2% of the outstanding assets at that time) generating \$2 million per year in fee income. The first transaction of \$25 million supporting the Port of Long Beach was executed in June 1994. As of September 30, 1999, the Credit Enhancement Program has approximately \$700 million in outstanding commitments producing an estimated \$2 million of fee income per year.

### **Current Market Environment**

The credit enhancement market utilizing letters-of-credit that CalSTRS operates in has undergone tremendous change in recent years. Five (5) to ten (10) years ago, the Japanese banks dominated the market with their AAA ratings. Since that time, the Japanese banks have left the market all together due to their low credit ratings. The U.S. banks have gone from retrenchment due to the recession in the early 1990s and tough competition from the Japanese banks to again being the leaders in U.S. banking due to the strong economic growth of the U.S. in recent years and the consolidation of U.S. banks. However, because of the consolidation and the Japanese banking problems, there are fewer banks available to provide credit enhancement through letters of credit.

The consolidation of banks and the Japanese retrenchment from the market have presented problems for portfolio managers in the tax-free money market funds that purchase such paper. Securities and Exchange Commission regulations limit portfolio exposure to no more than 5% for any credit enhancement provider. Hence, there is now a shortage of providers given the SEC limitations.<sup>1</sup>

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<sup>1</sup> “LOCs Are Back in the U.S.A. , But Lack of Players is a Problem”, *Bond Buyer*, Wednesday, August 18, 1999.

As outlined in the chart below, the credit enhancement market for letters-of credit in the U.S. is once again dominated by U.S. banks most of which have participated in the bank mergers and acquisitions activities in the U.S. over the past several years.

Top 10 Providers: First Half 1999 <sup>2</sup>

<b>Bank</b>	<b>Principal Am't (\$000)</b>	<b># of Issues</b>	<b>Market Share</b>
Bank of America	\$528.1	35	11.6%
Banc One	\$446.8	38	9.8%
Westdeutsche LandesbankGiroze	\$444.8	2	9.8%
First Union National Bank	\$359.4	28	7.9%
Wachovia Securities	\$287.6	22	6.3%
Landesbank Hessen-Thuringen	\$203.5	3	4.5%
Chase Bank	\$197.4	6	4.3%
Key Bank Corp.	\$162.6	4	3.6%
Fleet Bank	\$146.4	6	3.2%
Bayerische Hypo Vereinsbank Ag	\$128.6	4	2.8%

**Consortium Financial Group (CFG)**

Canadian Imperial Bank of Commerce (CIBC) has partnered with CalSTRS in the credit enhancement market several times over the past several years. In response to the evolving bank letter-of-credit market, CIBC has developed a new credit enhancement investment opportunity in the form of Consortium Financial Group (CFG). CFG is a consortium of pension funds that will pool their AAA ratings, make a financial commitment of credit enhancement funding, and provide credit enhancement on a national basis in the name of CFG.

**Business Description**

CFG will be a newly established financial service company created from a partnership of highly rated public pension funds (Member Funds). CFG's primary line of business will be to provide municipal clients with Credit Instruments that allow them to access the debt capital markets. The Credit Instruments will be in the form of Lines of Credit and Letters of Credit which have been traditionally provided by commercial banks. CFG will directly issue these instruments and in return will receive up-front structuring fees and on-going Commitment Fees. CFG will be rated "AAA". The "AAA" rating is based on the underlying credit ratings of each Member Fund.

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<sup>2</sup> Source: Securities Data Corp.

CFG's Mission Statement is to diversify each Member Fund's investment portfolio and to maximize fee income generation from public sector transactions consistent with the diligent application of sound credit analysis and judgment while minimizing risk through appropriate legal and time tested structural techniques.

CFG will structure and underwrite credit transactions to a zero loss standard and CIBC, acting as Service Agent (described below) to CFG, agrees to be bound by the standards of conduct applicable to a fiduciary of a public sector pension fund.

### Legal Structure

CFG will be a limited liability company organized under the laws of the State of California for the sole purpose of providing credit and liquidity support for municipal obligations. A limited liability company agreement among the member funds (the LLC Agreement) will govern the structure and operations of CFG. The LLC Agreement will provide for the ability of Member Funds to resign from, as well as new Member Funds to join, CFG.

### Potential Member Funds

Three (3) Member Funds are currently targeted as being part of the first closing: CalSTRS, Ohio STRS, and State University Retirement System of Illinois (SURS). There are several other potential members that would be included in a second round of funding. As a condition precedent to becoming a member, each Fund will be required to obtain a rating of "AAA".

### Initial Funding

CIBC will initiate the program by helping to arrange approximately \$1.5 billion of its \$2.5 billion in transactions which will be divided between the Charter Member Funds in CFG. The transfer of accounts will require the approval of the various entities currently being enhanced by CIBC. The AAA rating of CFG will be an attractive inducement for those entities selected to become clients of CFG. Charter Members may opt out of any transferred credit.

The initial amount of the Standby Master Letters of Credit is from \$2.5-\$3.0. The range of contribution from each fund will vary depending on the size of the respective pension fund. Each fund will initially make available from \$500 million-\$1 billion in the form of a Master Letter of Credit. The Master LOCs can be increased at any time at the approval of each Member Fund. The obligations will be on a several (not joint) basis based on their pro-rata share of transactions written.

### Service Agent

CIBC World Markets (CIBC) has been designated the Service Agent and will act as a fiduciary with respect to each Member Fund. All major decisions of CFG, as the appointment or termination of the Service Agent and the admission or removal of Member

Funds, will be made by unanimous decision of non-defaulting Member Funds. The Service Agent will act as manager of CFG with respect to the daily affairs and business of CFG and will be bound by the terms of the LLC Agreement pursuant to the Service Agent Agreement described below.

#### Service Agent Agreement

CIBC will operate and manage CFG under a Service Agent Agreement (SAA). The SSA will have a one-year term with automatic extensions. On an annual basis there will be an independent annual audit to ensure that CFG is in compliance with the SSA and other CFG requirements. Failure of CIBC to perform any of the key SAA requirements will result in default and will provide for CFG to immediately replace CIBC. The Member Funds will have the right of control, under the SAA, with respect to a replacement SAA provider based upon a number of factors including servicing capabilities, operational expertise, and knowledge of and commitment to the industry.

The *key* duties and responsibilities of CIBC will include:

1. Originate, negotiate, document and issue all Credit Facilities. CIBC will be granted power of attorney to execute on behalf of CFG.
2. Provide full operational support and billing services for CFG.
3. Provide ongoing surveillance, credit monitoring, and statistical reporting of the Credit Facilities portfolio to each member.
4. Any applicable post negotiation which includes amendments, waivers and restructuring of the Credit Facilities. Under the SSA, CIBC will act upon the direction of the Member Funds.
5. A Line of Credit to CFG from CIBC will be used to accommodate same day funding requirements.
6. The hiring of competent staff and consultants, as necessary.

Under the Service Agent Agreement, CIBC will be *required* to do the following:

1. Prepare a Credit Policy, Procedures and Guidelines (Credit Guidelines). These guidelines will be approved annually by each of the member funds.
2. Make full documentation on each Credit Instrument. This will include all pertinent legal documents and other internal credit due diligence material.
3. Generate a Portfolio Report that fully describes each Credit Instrument and includes each Member Fund's allocation of the portfolio and associated revenue. The portfolio report will be updated on a daily basis.
4. Prior to the issuance of any Credit Instrument, CIBC will make available to each Member Fund a Memorandum of Issuance (MOI). The MOI will fully describe the financing and where it falls within the pre-approved Credit Guidelines.
5. For each Credit Facility issued, CIBC will enter into a risk Participation Agreement (PA) for an amount equal to 3% of the underlying transaction. CIBC will approve each transaction independent of CFG. If CIBC declines the transaction, CFG can not process the deal.

6. CIBC shall make available a First Loss Facility of at least \$20 million (may be negotiated to a higher amount), provided by an AAA insurer acceptable to each fund.

All of the above referenced reports and forms will be prepared and approved, as to format and style, by all parties prior to the Closing Date. All information and portfolio data will be available to each Member Fund on a 24-hour basis via a highly secured Internet service.

#### CIBC Existing Portfolio

In order to achieve immediate revenue generation, CIBC will make available certain Credit Instruments within their existing portfolio for inclusion into CFG. The intent is to negotiate the transfer only the highest quality and highest yielding assets into CFG. The group of assets to be transferred will have an underlying credit rating of BBB+ or better. Any clients and/or Credit Instruments that are made available for inclusion into the CFG portfolio will be subject to CFG Credit Policy and Guidelines.

#### CalSTRS Existing Portfolio

The CalSTRS Credit Enhancement portfolio, as of September 30, 1999, has outstandings of approximately \$700 million. The current policy allows CalSTRS to provide credit enhancement to California and its contiguous states. CFG will be positioned to also provide credit enhancement in the CalSTRS target territory. Every effort will be made to ensure that CFG compliments and strengthens the existing CalSTRS Credit Enhancement Program.

#### Projected Outstandings and Fee Income

The chart below demonstrates the projected fee income and outstanding commitments for the CFG portfolio. CFG is expected to become a market leader in the segment of the credit enhancement market that relies on Lines of Credit and Letters of Credit. As the program grows, it is expected that a combination of increased commitments from existing Members and new Members will account for the increased underwriting capabilities of CFG.

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Total Portfolio	\$2.6 Bil	\$4.8 Bil	\$7.7 Bil	\$9.9 Bil	\$12.1 Bil
Fee Income	\$8.4 Mil	\$15.5 Mil	\$25.2 Mil	\$31.8 Mil	\$38.2 Mil

### CFG Revenue Distribution

The revenue distribution for CFG is as follows:

<b>Revenue</b>	<b>1) Member Funds</b>	<b>2) CIBC</b>	
Annual Commitment Fees	80%	20%	
Up-front Structuring Fees	50%	50%	
Interest on Funded Bond Purchases	100%	0%	
Operational Draws, Amendment and Waiver Fees	0%	100%	

As provided in the SAA, CIBC will distribute all fees, charges and interest income and revenues to 1) each Member Fund (based on their pro-rata share) and 2) CIBC. CFG members will receive 80% of all annual commitment fees and 50% of up-front structuring fees. In the event there is a funded bond purchase, the trustee would draw on the Master Letter of Credit.

### CFG Expenses

The Service Agent will pay for all costs and expenses associated with the start up and on-going operation of CFG. This includes up-front legal costs and on-going CFG costs including all salaries, marketing, and administration expenses. The only expense contemplated for the account of the Member Funds is the cost of obtaining and maintaining their own credit rating(s).

### CFG Portfolio – Geographic Distribution

The CFG Portfolio will have a Geographic Distribution that will be comparable to the spectrum of municipal debt issuance across the market. Since debt issuance is correlated to population, the CFG portfolio will be aligned with states having the largest population. The ten (10) States below have the largest volume of municipal business and should comprise approximately 55-60% of the CFG portfolio as it matures.



	<b><u>Market Data</u></b>			<b><i>Current CIBC Portfolio</i></b>	<b><i>CFG Target Portfolio</i></b>
	<b>% of Total Long Term Bond Market</b>	<b>Variable Rate Volume*</b>	<b>Annual Variable Debt Issued**</b>		
California	12 – 16 %	12%	\$3,536	27%	<b>25%</b>
New York	12 – 16 %	10%	\$2,518	8%	<b>12%</b>
Florida	5 – 7 %	9%	\$1,082	1%	<b>5%</b>
New Jersey	2 – 4 %	5%	\$284	0%	<b>5%</b>
Texas	3 – 5 %	11%	\$1,766	5%	<b>6%</b>
Pennsylvania	5 – 7 %	14%	\$1,396	8%	<b>7%</b>
Illinois	2 – 4 %	18%	\$1,748	1%	<b>5%</b>
Massachusetts	2 – 4 %	9%	\$662	7%	<b>5%</b>
Michigan	2 – 4 %	8%	\$507	7%	<b>5%</b>
Ohio	2 – 4 %	16%	\$1,246	3%	<b>5%</b>

\* 3 year average as a percentage of Total Volume

\*\* 3 year average in millions

### CFG Credit Quality

The CFG credit quality will center on the A rating designation. The chart below indicates the target percentages for each category from AAA to BBB. In the event of a transaction that is of credit quality, but does not have a rating source, a documented rating will be acquired. This rating may take the form of a “shadow rating” by one of the rating agencies. A “shadow rating” is an unpublished indication by the rating agency of the rating for a particular transaction.

<b>CIBC Risk Management Rating Code</b>	<b>Rating Category Designation *</b>	<b>CFG Ratings Category Target Portfolio</b>
0-1	AAA	Less than 3%
1-2	AA	18 – 22%
2-3	A	30 – 35%
3-4.5	BBB	30 – 35%

Additional features and background on the Consortium Financial Group can be found in the following exhibits:

Exhibit A – CFG’s U.S. Municipal Market Overview, pp. 9-18

This exhibit outlines the U.S. Municipal marketplace, the market’s use of credit facilities, CIBC Portfolio and Performance, Role of Remarketing Agents, and Summation of CFG’s Credit Policy Introduction.

Exhibit B - CFG LLC Memorandum of Key Structural Terms and Conditions, pp. 19-22

Provides the business description, legal structure, and service agent agreement from the program. It also states that an independent audit of the program will be conducted.

Exhibit C - CFG LLC Pro-Forma Fee Income Projections, p. 23

Outlines the fee income projections for five years.

Exhibit D - Consortium Financial Group Credit Policy, pp. 24-28

This exhibit describes the mission statement, credit approval policy and procedures, types of credit instruments, and effective dates of the credit policy guidelines.

Exhibit E - Consortium Financial Group Credit Policy Guidelines, pp. 29-36

This exhibit outlines seven (7) guidelines that the Program will operate under. These guidelines include Member Fund Limits, municipal sector limits, credit rating risk, geographic distribution, etc. The Credit Guidelines will be updated and approved annually by each Member Fund.

## **Consortium Financial Group LLC (CFG)**

### **U.S. Municipal Market Overview**

#### **I. Introduction to the U.S. Municipal Marketplace**

The municipal finance industry revolves around a very mature municipal marketplace in which governmental entities and not-for-profit (501 (c) 3 organizations) issue tax-exempt notes and bonds. There are over 35,000 such entities in the U.S. virtually all of which can access this market based on the merits of their own credit. The notes or bonds of mid-size and larger issuers are generally rated by Standard and Poor's ("S&P"), Moody's Investors Service ("Moody's"), or Fitch IBCA, Inc. ("Fitch"), and confer an independent credit assessment upon the issuer. Smaller, non-rated issuers also enjoy strong market acceptance through local banks that purchase these securities (and enjoy certain U.S. tax code deductions owing to the small issuer exemption which allows banks to deduct the cost of debt used to purchase these qualified securities) or through an active placement marketplace.

The municipal market generates a stable source of annual new issuance volume. When viewed over the long term, the supply of new debt typically increases at a steady rate of 3% to 5% per year. The Bond Market Association ("BMA") estimates that there are now over \$1.5 trillion in outstanding securities held by investors. This rather modest rate of growth reflects several factors. Among these are the fact that taxpayers represent an important check on the system and

are reluctant to approve taxes and/or user fees in excess of certain income levels (the ability to pay factor) and the fact that municipal governments, knowing that obtaining approval for new projects can be difficult, tend to self-prioritize new debt issuance to support the most important, most productive investment (the willingness to pay factor). While the nation's infrastructure backlog is estimated in the trillions of dollars, new debt issuance matches income and employment levels, or stated another way, the ability and willingness to pay. Even despite the very strong economy the U.S. has had over the last 5 years, the "surplus" in many states and cities is being used to reduce taxes, rather than support new debt. There are so few incentives to "over-issuance" that volume increases slowly over time and accounts for the market's strong financial and debt repayment history.

The only two exceptions to the comments above result from the fact the public finance marketplace is highly counter-cyclical and that debt issuance, in particular note volume, tends to increase in times of economic and financial stress. In order to manage the timing mismatch between expenditures (that are largely fixed) and revenues which are slower to be realized during a downturn, issuers turn to the note market which allows an issuer the ability to smooth out the timing differences between receipts and expenditures. Note volume, particularly in the 1980-1982 and 1990-1991 recessions increased and

thereby resulted in a higher than normal increase in new issue volume in these periods. The second exception is the aggressive approach municipal issuers take to reduce debt service costs. As interest rates decrease, state and local governments actively refinance high coupon debt into lower coupon debt, thereby reducing interest costs. In these periods, volume again is above its “normal” long-term growth profile. In the case of note issuance, the municipal market is simply taking a prudent step in aligning revenues with expenses and in the later case, is prudently managing its debt service expenses.

## II. Market’s use of Credit Facilities

As a further reflection of the prudent management techniques municipal governments undertake in reducing expenses, is the ability to use and manage credit facilities (letters of credit and lines of credit) to take advantage of lower coupon debt structures at the shorter end of the yield curve. Issuers may elect to use credit enhancement facilities to realize overall debt service savings or to ensure broad market acceptance. Credit enhancement usually takes the form of a bond insurance policy (from one of five monoline insurers) or a bank letter of credit facility. Banks also provide lines of credit for variable rate debt when no credit enhancement is deemed necessary a feature that CFG will have, and which provides an important long-term competitive advantage. Bond insurers currently enhance about 52% of the fixed rate new issuance volume each year. Banks enhance mostly variable rate debt and have a relatively small share of the overall market, typically 15

– 25% of annual new issuance volume. This is CFG’s target market.

Several very important characteristics about this credit enhancement market should be clearly understood:

First, credit enhancement is a relatively new product. Bond insurance has only existed since 1975, when AMBAC issued its first insurance policy. Commercial banks began to have a role in the municipal market with the advent of variable rate structured debt. Prior to 1980, all municipal debt was sold on a fixed rate basis. In the early 1980’s, the tax-exempt housing market issued the first ever variable rate, long-term securities. In addition, it wasn’t until the mid-1980’s that the states and larger entities, to meet cash flow imbalances between receipts and disbursements, secured the first letters of credit on large note deals. Therefore, the bank credit enhancement market for municipal bonds is only about 20 years old, while the overall market is over 150 years old.

Second, credit enhancement via bond insurance or a letter of credit is usually not associated with issuers that do not have market access. Today, there are only a handful of non-investment grade issuers in the U.S. Enhancement is largely an arbitrage play (i.e., paying X basis points for a letter of credit, but saving X + 20 basis points in overall debt service costs) because the debt is sold on the enhancer’s rating and not on the underlying issuer’s rating. Liquidity facilities are simply vehicles to accommodate a municipality’s desire to sell floating rate debt. It is a requirement of the rating agencies to have dollar for dollar liquidity. In addition, since variable rate debt is typically sold to short term tax-exempt money market funds, which have 397-day maturity limits, the liquidity feature is a requirement the funds must have so as to be able to purchase nominal debt maturities of 20 to 30 years, while being able to satisfy the 397 day test. Therefore, credit

enhancement facilities save issuers debt service costs and may improve market access, but they are not essential to ensure market access.

The role of short-term tax-exempt funds is vital to this market. This is because an individual investor's tax position changes over time. With the exception of institutional buyers' corporations or insurance/finance companies, most tax-exempt buyers are not looking for 20 or 30-year tax shelters. As income changes during the course of a lifetime, the need for tax-exempt income changes. Short-term money market funds fill the role of being in the middle i.e., as new purchasers enter, others, who have no tax shelter needs, leave. The overall short-term, variable rate market approximates \$350 Billion and is held by over 400 different funds. This continued inflow-outflow means that the tax-exempt short-term funds are a permanent feature in the market and that CFG's role is likewise important in providing high quality liquidity needs for these funds.

Because of its long standing history, dating back over 150 years, the municipal market has established well-defined expectations for its borrowers and in addition has the ability to exert considerable discipline on its participants. In fact, disclosure and oversight in the municipal market have never been higher. There continues to be an evolution in municipal disclosure, with greater emphasis being placed on timely reporting and notices to investors of material events. Both the SEC and IRS have, through these independent agencies, aggressively pursued cases designed to send strong, clear signals to the market on issues ranging from pay to play, to yield burning. Although the SEC does not directly regulate municipal issuers, they do regulate the broker-dealer community and it is through that enforcement that changes are being promulgated. The municipal market's own oversight board, the Municipal Securities Rulemaking Board ("MSRB") continues to

focus on all manners of disclosure, ranging from bond pricing to political influence and relationships with financial intermediaries. Combined with the rating agencies and other independent organizations that act as a "watchdog", such as the Citizens Budget Commission which oversees and comments on N.Y. City's and N.Y. State's finance and budgeting practices, the improvement in disclosure and "sunshine" practices has been substantial and provides a very solid foundation upon which to make credit decisions.

Third, continued market access for issuers is absolutely essential. State and local governments in the United States have only one source of funding for the substantial infrastructure and working capital needs necessary to maintain economic prosperity: tax-exempt notes and bonds. The purpose of the tax-exempt market is to provide low cost, efficient financing for such purposes to a wide variety of issuers. Of the over \$1.5 trillion in tax-exempt bonds outstanding, most were issued for "bricks and mortar" and therefore represent an investment in future economic growth. Because governments have only one market, they take continuing actions to preserve it. A case in point is the action the City of Philadelphia took in 1992 to assure investors that it was taking all appropriate steps to assure timely debt repayment. During this period, the City escrowed one full year of debt service (in addition to various other debt service reserves) so as to be able to promise investors they would be repaid. In times of stress, issuers tend to take these and other steps to assure investors on their continuing commitment to pay. The three most recent cases of default, Orange County, California, City of Cleveland, and the N.Y. City were all resolved favorably to debt holders. In all cases, investors received 100¢ on the dollar, reflecting the importance of maintaining investor confidence and continued market access.

Fourth, the use of the municipal marketplace for deficit financing purposes is extremely rare and kept to an absolute minimum. In fact, since 1995, no municipal issuer has sold such an instrument. Short term cash flow financing to cover timing imbalances; however, is an important component of the market since governments do not have the deep banking relationships or access to the equity markets that many corporations enjoy. Note financing, to surmount imbalances between receipts and disbursements, is common in times of economic stress or recessions.

Fifth, there are certain inherent credit strengths in the municipal bond market. In most cases, municipal services are monopoly in nature. The essential nature of III. municipal bond financing, combined with a voter or legislative authorization to incur debt, are the reasons that the incidence of default and non-payment of this sector of the capital market is negligible. In 1998, there were 18,901 new issues for a total of \$320.5 billion, fairly typical of volume levels seen in recent years. In the prior year for which data is available, there were only 40 defaults totaling \$1.601 billion, or about one-half of 1% of new issue volume. Keep in mind that these include non-material technical defaults and that actual payment defaults are a fraction of the above percentage. Over 50% of the defaults were attributable to pre-development housing bonds, electrical power bonds, or industrial development bonds (which, while tax-exempt reflect corporate, not municipal risk). These categories are not a primary target focus for CFG.

Sixth, the primary uses of debt proceeds have not changed significantly over the years. School facilities, water, sewer, and electric facilities, mass transit, highways, and public buildings and infrastructure still dominate the list. Four other areas of tax-exempt financing, which are not strictly "municipal" include the areas of health care, not-for-profit organizations, housing, and

industrial development, all of which are sizable markets. CFG will selectively pursue key opportunities, but will define its target market in these segments carefully as further described below. CFG will concentrate on mainstream municipal finance debt issued by the full range of state and local governments, mass transit authorities, airports, port authorities, special purpose districts, and stadiums and other projects with substantial governmental and tax support. In addition, well managed and politically supported areas such as tax-increment financing and debt issued by non-profit organizations represent tremendous opportunity for CFG.

#### CIBC Portfolio and Performance

As noted, CIBC has historically targeted a select group of municipal debt issuers, both by size and type of security. The portfolio today is largely state level issuers or very large local governmental issuers who have sold general obligation bonds or revenue bonds backed by a strong and predictable pledged revenue stream. Over the last six years Public Finance has expanded its target market to include more revenue bond issues, which constitute about 65% of all municipal bonds sold. At this point about 25% of the portfolio is comprised of general obligation bonds, with the remainder comprised of revenue bonds and lease revenue bonds, which are subject to annual payment appropriation.

Subordinate debt obligations comprise an increasing portion of the municipal bond market, particularly for commercial paper programs used to fund capital projects prior to the issuance of long term debt. These obligations now comprise about 20% of the CIBC Public Finance portfolio. In general, the risk profile of a subordinate lien bond does not differ greatly from the senior lien debt. The subordinate obligations are backed by the same pledged revenue stream, but generally have somewhat lower rate

covenants or additional bond tests. The history of subordinate lien debt is not statistically different from senior lien debt.

Unlike corporate subordinated debt which does, in fact, have an inferior claim on cash flow, municipal subordinate lien obligations enjoy a parity position in the rate setting mechanisms (i.e., water rates, airport landing fees, etc.) that are set to cover all debt, regardless of lien position. The rate covenant must be set to cover all obligations. This is the reason why there is no significant difference in history among municipal senior or subordinate lien debt.

While CFG will continue to focus on larger governments and governmental authorities, debt issues of smaller entities (under 50,000 population) are also to be considered on a case by case basis as discussed below. The repayment history of these areas of Public Finance is virtually identical to those now in the portfolio and they warrant consideration given the highly competitive environment in which CFG will operate. Looking over default history for the last 150 years, there is no correlation of default with population size. Our firm's experience with Canadian debt issuers bears this out in a parallel market.

**The historical performance of CIBC's portfolio has been excellent with few amendments, no credit restructures and no credit defaults to date.**

### **3) Key Credit Risk Assessment Norms**

As an enhancer or liquidity provider to entities selling debt securities in the capital market, CFG will benefit from the solid protections built into such securities to protect the bondholders. Nonetheless, a thorough credit evaluation is undertaken before seeking credit approval for any customer.

The single most important credit consideration in assessing a municipal credit is the security pledge available and the analysis of the cash flow behind the pledge. In the vast majority of cases, the pledge consists of a general obligation full faith and credit pledge, or a user-fee based pledge on the provision of an essential service on an exclusive basis. In other words, most municipal services (water and sewer, toll bridges, airports) operate as monopolies. Unlike corporations, these entities are not in direct competition with other service providers. Bonds are issued by governmental entities that are constitutionally and statutorily empowered to collect revenues in order to provide both mandated services and promote economic development through capital outlays. Enforcement provisions for such revenue collection are strong and well tested for virtually all levels and size of government.

Of course, certain events could conspire to reduce the cushion available to repay debt obligations. While governments are not subject to "event risk" or other uncertainties, with the possible exception of initiatives and referendums, changing intergovernmental relationships and mandates can put sudden or severe pressure on operating budgets. However, since revenues raised to pay debt service are separate and distinct and not generally available to pay operating expenses, an operating crisis does not materially impact the ability or willingness to repay debt. There is strong incentive to pay bondholders so as not to jeopardize the ability to access the municipal market unless an issuer has experienced a very rare total economic and fiscal collapse. In fact, it is particularly in time of fiscal stress that the municipal market is of utmost importance to issuers. CIBC's prior experience with Philadelphia, Washington D.C and the

Commonwealth of Massachusetts, all of whom temporarily suffered higher financing costs due to fiscal stress and rating downgrades, are good examples.

The four broad areas of credit evaluation used in assessing municipal credit revolve around the factors of debt, financial, socioeconomic and administration. Under debt factors, the key elements are per capita debt (generally \$500-\$1,000), debt to the estimated full market value (5-10%), debt service as a percent of expenditures (8-12%) and the amortization schedule (30-50% of debt due within 10 years). Other considerations are the debt limits and unused borrowing capacity (at least 20%) and future capital needs (consistent with historical patterns). When applicable, CFG will use median debt ratios from Moody's Investor Service. The reasons for significant deviations from the medians will be discussed in the Memorandum of Issuance ("MOI").

Under financial factors, consistently balanced budgets with a cumulative positive ending fund balance position of 3-5% of the budget are the ideal fiscal posture. However in times of recession, most entities have difficulty maintaining equilibrium. Short-term financial dislocations generally are corrected within 1-2 fiscal years due to mandatory balanced budget requirements. It is; however, during such dislocations that CIBC is presented with the most business opportunities with respect to cash flow borrowings. During such periods both the number of issuers and the size of the issues increase and are opportunities worth pursuing. Given the average short tenor guidelines for CFG's portfolio, these high return opportunities should be considered. The public finance market is highly counter-cyclical when fees and opportunities are considered.

In analyzing cash flow on revenue bond issues, the ratemaking authority of the entity is the key consideration. For a public water

and sewer system with fairly predictable usage, coverage of 1.20x to 1.50x provides sufficient annual margin; for sales tax bonds coverage of 1.50x to 2.00x; for other special tax bonds 1.75x or higher may be warranted depending on the quality of the revenue source and the ability to change or raise revenues. For a State-shared revenue pledge, the quality is generally higher because of the geographic diversity of the base on which the revenues are collected. The ability and willingness of these entities to effect changes i.e., increasing the tax rate or adding to items subject to the tax plus the monopoly status, has resulted in the excellent performance history.

The socioeconomic factors cover a broad range of variables including population growth (preferably consistent with State and region) income indicators (also in line with regional medians), other economic activity (retail sales, building permits) and a diversified mix of taxpayers and employers as closely aligned to the national averages as possible to assure that the economy and employment base are cushioned from extreme cyclical fluctuations.

Under administrative factors, it is important to examine the governmental structure, manner and frequency of elections, statutory and charter powers and limitations, and the experience and depth of the management team. It is CFG's position that the caliber of both the elected and appointed public officials is quite high and the electorate is equally knowledgeable resulting in a degree of accountability that maintains a healthy balance between the executive and legislative branches of government. Sophistication of management is increasing, aided by tremendous investment growth over the last 7-10 years in information management and reporting systems. The level of expertise of finance professionals in the municipal market has never been higher.

Strict adherence to restrictive covenants and legal provisions is required of all



participants in the municipal marketplace. Covenant waivers are very rare as an Indenture requires majority bondholder approval. Since bonds are so widely placed, this requirement is nearly impossible to fulfill without a complete refunding of the debt. Therefore, CFG will not assume the myriad uncertainties in enhancing public finance debt that accompany more traditional two-party lending. Amendments and waivers of covenants are exceedingly rare in the municipal world. Governments must legally and practically honor their debt commitments on the terms initially specified.

#### **V. Protection afforded by flow of funds**

All revenue bonds, which comprise the largest share of municipal securities sold today, are subject to strict, trustee-enforced flow of funds. The trust indenture governs use of proceeds and the application of funds for the benefit of bondholders as those funds are received.

Within the indenture, there is a clear order of payment priority for the application of funds as they are remitted to the trustee. The importance of a well structured indenture cannot be overstated. Since various revenues may be pledged to repay debt and since the issuer may be the recipient of funds from another governmental entity, the indenture provides lenders with legal protection against the unlawful use of funds for any other purposes. In other words, once legally pledged, revenues are not subject to intercept, set-off or any other claim. This feature is also part of the unique accounting treatment municipalities operate under -- the earmarking of funds for certain purposes. For example, special revenue

funds reflect the use of dedicated monies for only certain, well described uses and are accounted for this manner.

#### **Parties to Municipal Bond Transactions**

In general, the municipal market is highly concentrated with respect to the major, leading legal and financial service providers. For example, the top 10 municipal bond underwriting firms have approximately a 65% market share.

Among the parties to a “typical” municipal bond transaction, including bond counsel, financial advisors, underwriters counsel, trustees and remarketing agents, the 10 top players have a similar market share. The municipal market, given strong competition and the benefits from economies of scale, tends to be dominated by the larger, more sophisticated players.

CFG, in originating transactions, will be involved with these players, and more often than not, will deal with them on a regular basis. An important component of CFG's early success will be the swift completion of a transaction with a professional level of timely service. CIBC's staff is familiar with all of these key service providers and will quickly be able to establish CFG as the industry standard and provider of choice.

#### **VII. Key Role of Remarketing Agents**

CFG's portfolio will be substantially comprised of variable rate debt. Therefore, the role of the remarketing agent, usually an investment bank, is essential in keeping the variable rate paper (typically the interest rate is re-set weekly or daily) in the hands of investors. It is the role of the remarketing agent to maintain buy-side contacts and maintain orderly markets for this debt. The remarketing agent has the ability to set the interest rates at a “market clearing rate”,

thereby allowing the interest rate to rise if necessary to attract sufficient buyers. By convention, most remarketing agents willIX. hold un-sold paper (overnight or over the weekend) in inventory within their firms. The reason a remarketing agent does this is to avoid the competitive pressure and adverse publicity that they would face if they were to put the paper to CFG. A reputable remarketing agent, with a long track record and a substantial book of remarketed paper is important and is a key part of any evaluation CFG undertakes. CFG will have the right to approve the initial and any subsequent replacement remarketing agent.

#### VIII. Industry-Specific Due Diligence

The policy of CFG is to know its borrower through both marketing efforts and due diligence visits, preferably prior to being selected to provide enhancement. The discussions are wide-ranging, covering the political landscape, debt and fiscal policies and the outlook for economic development. These issues are fully explored prior to credit application submission. In addition, since many issuers are not overly familiar with the emerging credit enhancement business, one of CFG's key jobs is to explain the role CFG will play in the capital formation process and how CFG facilitates that process. The legal documentation that accompanies a transaction is generally standard in form, time tested, and undergoes a thorough discussion with the issuers and, in several states, is vetted by a State's Attorney General. Bond Counsel opinions are carefully reviewed and attest to the legal nature of the bond contracts and the valid pledge of revenues to repay the securities.

As part of the credit due-diligence process, CFG will retain memorandum key documents and other supporting material that were discussed in these due-diligence meetings and which are used in the credit decision making process.

#### Appropriate Structures and Terms

When providing liquidity facilities for short-term variable rate notes or commercial paper programs, terms of 1-3 years are generally acceptable. For long-term variable rate bond issues, a term of 5-7 years is desirable. For long term fixed rate bond issues, terms of 7-12 years are desirable to avoid early call provisions on the bonds which can be costly to the issuers. Bank facilities often include a seldom, if ever, used feature known as a term loan. Such term loan tenors are typically 1-5 years in duration and are available at maturity of the facility in the event the letter or line of credit is not extended and no replacement is obtained. While the issuers or rating agencies may require such term loans for additional comfort, they have never been drawn on in CIBC's nine years of existence, nor are we aware of any other problematic situations in other banks portfolios. The benefit of such facilities is that these term loans are incorporated into CFG's initial documentation and therefore are pre-negotiated terms for repayment. In other words, the repayment schedule of any future downside scenario is covered off on prior to closing. The interest rate on term loans is based on the Prime Rate or other published index such as Libor, plus a large credit spread—up to 4%. This is known as “drive away pricing” and is intended to incentivize an issuer to refinance away from CFG.

Facilities for revenue bond issues will usually include a rate covenant, tantamount to a minimum debt service coverage ratio, typically 1:20 - 1:50 times, and an additional debt test of similar magnitude. CFG will prefer transactions in which the additional debt test is based on both a historical and a future coverage basis. CFG may on occasion seek to have stricter covenants than those offered to bondholders included in the bank documentation. Accordingly, in these cases, the protection afforded CFG is

actually higher than the security rated by the rating services.

Another important factor to note about this market is that while CFG will be providing credit or liquidity support on a bond with a nominal maturity of 20 – 30 years, the “average-life” of a municipal bond is only 12 years. The chances of holding a municipal security for its full duration are highly remote. The short-term duration will tend to shorten the nominally indicated weighted average maturity calculation as the credit facilities seldom run their full initialXIV. started term.

## **X. Externals Oversight Factors**

Various governmental agencies, offering direct and in-direct oversight of the U.S. municipal market, provide additional comfort on the continuing performance of debt repayment.

The SEC does not directly regulate municipal issuers, but does regulate the broker-dealer community and has focused its powers on making improvements regarding underwriters and sales force personnel in disclosure and in not providing misleading information. The IRS has continued to step-up its audit program and has generally increased its scrutiny of “abuses”, particularly arbitrage related transactions.

The market’s own self-regulatory body, the Municipal Securities Rulemaking Board (“MSRB”) likewise is focusing more on timely disclosure and “transparent” pricing data for securities. All in all, these and other agencies are committed to maintaining the highest ethical, disclosure, and performance standards for municipal issuers.

## **XIII. Establishing Asset and/or Security Value**

The security pledge of a municipal government revolves around its pledge of

certain earmarked taxes and/or revenues, rather than a security interest and/or mortgage in fixed assets. The former pledge is considered superior and, in addition, the possible foreclosure and repossession of a municipal asset is impractical at best and often not legally available. Other common features that may secure corporate debt, but not municipal obligations, are filings to secure inventory or accounts receivables, land or other fixed assets.

## **Summation of CFG’s Credit Policy Introduction**

In summary, the following recap sets out the essential features in the municipal market and CFG’s role in the capital formation process:

- CFG will target the highly essential “municipal” portion of the tax-exempt marketplace. In addition, selected transactions in healthcare, housing, non-profit organizations and industrial development bonds will be considered on their merits. Non-investment grade and non-rated issues will be considered, subject to appropriate due-diligence and appropriate structuring and the CFG established non-investment grade “basket”.
- The security pledges offered to the bondholders and CFG are of high quality, time tested and enforceable. CFG will follow well established, market convention on documentation and security.
- All industry-wide and rating agency standards of evaluating municipal credit quality, combined with CIBC’s own unique experience, will continue to guide the decision making process.
- The goal is to maintain a diversified CFG portfolio of an average tenor of 3 to 5 years.
- While CFG will target the larger State, City, County and major agencies/authorities thereof, the default history of this market is not correlated with size of a municipality’s budget or population. The profitability, however, is inversely correlated with

population size, thereby making smaller entities viable, profitable opportunities on a case by case evaluation.

- Publicly available data on municipal performance attests to the strength, durability and strong financial performance in the debt markets. External enforcement agencies that are in a “position of influence” have further strengthened the performance and overall disclosure in the municipal market.
- Market forces, along with an inherently conservative debt management practice, accounts for the excellent history of this market. During the strong U.S. economy of the last few years, States and local governments have seen upgrades across all sectors. Surpluses of the strong economies have been invested in new information management systems (to reduce human

resources and improve service with lower costs) or have been put into “rainy day” surplus funds.

- As a counter-cyclical business, the greatest opportunities are seen in the more difficult economic times. CIBC’s collective experience with the parallel market in Canada, when added to the above argument, gives CFG a large competitive advantage in working with and understanding the needs of governmental issuers in all segments.
- In general, management and financial systems are very solid and provide a reliable foundation on which to make sound credit judgments.

**Consortium Financial Group LLC (CFG)**  
**Memorandum of Key Structural Terms and Conditions**

Name:	<b>Consortium Financial Group LLC (CFG)</b>
Business Description:	CFG will be a newly established financial service company created from a partnership of highly rated public pension funds (Member Funds). CFG's primary line of business will be to provide municipal clients with Credit Instruments that allow them to access the debt capital markets. The Credit Instruments will be in the form of Lines of Credit and Letters of Credit which have been traditionally provided by commercial banks. CFG will directly issue these Credit Instruments and in return will receive Up-front Structuring Fees and on-going Commitment Fees. CFG will be rated "AAA". The "AAA" rating is based on the underlying credit ratings of each Member Fund.
Legal Structure:	CFG will be a limited liability company organized under the laws of the State of California for the sole purpose of providing credit and liquidity support for municipal obligations. A limited liability company agreement among the Member Funds (the LLC Agreement) will govern the structure and operations of CFG. The LLC Agreement will provide for the ability of Member Funds to resign from, as well as new Member Funds to join, CFG. All income of CFG will be passed back to the Member Funds on a pro-rata, pre-tax basis. The assets of CFG will consist of the reimbursement and liquidity agreements entered into by CFG and any bonds purchased pursuant to such agreements or other security realized upon in the unlikely event of a default. All major decisions of CFG, as the appointment or termination of the Service Agent (as described below) and the admission or removal of Members Funds, will be made by unanimous decision of non-defaulting Member Funds. The Service Agent will act as manager of CFG with respect to the daily affairs and business of CFG and will be bound by the terms of the LLC Agreement pursuant to the Service Agent Agreement described below. As a condition precedent to becoming a member of CFG, each Member Fund will be required to obtain a rating of "AAA" as described above, and to deliver certain closing documents and certificates including an opinion of counsel to such Member Fund on a Member Funds ability to legally provide credit instruments.
Closing Date:	1 <sup>st</sup> Half of 2000.
Charter Member Funds at Closing:	<b>California State Teachers Retirement System (Cal STRS)</b> <b>The State Teachers Retirement System of Ohio (Ohio STRS)</b> <b>State University Retirement System of Illinois (SURS)</b>
Initial Amount of Standby Master Letters of Credit:	\$2.5 - \$3.0 billion. Each of the identified Member Funds will initially make available from \$500 Million - \$1 Billion each in the form of a Master Letter of Credit (Master LOC). The Master LOCs can be increased at any time at the approval of each Member Fund.

Obligations to CFG: Each Member Fund shall be obligated on an unconditional basis to fund CFG under the Master LOC on a several (not joint basis) based on their pro-rata share of transactions written.

Service Agent: CIBC World Markets (CIBC), acting as a fiduciary with respect to each Member Fund.

Service Agent Agreement: CIBC will operate and manage CFG under a Service Agent Agreement (SAA). The key duties and responsibilities of CIBC will include:

1. Originate, negotiate, document and issue all Credit Facilities. CIBC will be granted power of attorney to execute on behalf of CFG.
2. Provide full operational support and billing services for CFG.
3. Provide on-going surveillance, credit monitoring and statistical reporting of the Credit Facilities portfolio to each Member Fund.
4. Any applicable post negotiation which includes amendments, waivers and restructuring of the Credit Facilities. Under the SAA, CIBC will act upon the direction of the Member Funds.
5. A Line of Credit to CFG to accommodate same day funding requirements.
6. The hiring of competent staff and consultants, as necessary.

Term of SAA: One-year with automatic one-year extensions.

Revenue Distribution: As provided in the SAA, CIBC will distribute all fees, charges and interest income and revenues to 1) each Member Fund (based on their pro-rata share) and 2) CIBC, the following:

<b>4) Revenue</b>	<b>5) Member Funds</b>	<b>6) CIBC</b>		<b>1<sup>st</sup> Year Totals (000's)</b>
Annual Commitment Fees	80%	20%		<b>\$9,880</b>
Up-front Structuring Fees	50%	50%		<b>\$1,900</b>
Interest on Funded Bond Purchases	100%	0%		<b>\$0</b>
Operational Draws, Amendment and Waiver Fees	0%	100%		<b>\$220</b>

Expenses of CFG: All costs and expenses associated with the start up and on-going operation of CFG will be paid for by the Service Agent. This includes up-front legal costs and on-going CFG costs including all salaries, marketing, and administration expenses. The only expense contemplated for the account of the Member Funds is the cost of obtaining and maintaining their own credit rating(s).

Key SAA  
Requirements:

Through the SAA, CIBC will be required to do the following:

1. Prepare a Credit Policy, Procedures and Guidelines (Credit Guidelines). The Credit Guidelines will be submitted to each Member Fund and updated annually. The Credit Guidelines will be approved annually by each of the Member Funds.
2. Make available full documentation on each Credit Instrument. This will include all pertinent legal documents and other internal credit due diligence material.
3. Generation of a Portfolio Report that fully describes each Credit Instrument issued and includes each Member Fund's allocation of the portfolio and associated revenue. The Portfolio Report will be updated on a daily basis.
4. Prior to the issuance of any Credit Instrument, CIBC will make available to each Member Fund a Memorandum of Issuance (MOI). The MOI will fully describe the financing and where it falls within the pre-approved Credit Guidelines. Per the SAA, all Credit Instruments must be within Credit Guidelines.
5. For each Credit Facility issued, CIBC will enter into a Risk Participation Agreement (PA) for an amount equal to 3% (subject to change) of the underlying transaction.
6. CIBC shall make available a First Loss Facility in the amount of \$20 million. This Facility shall be provided directly by CIBC or a Triple A insurer acceptable to each Member Fund.

All of the above referenced reports and forms will be prepared and approved, as to format and style, by all parties prior to the Closing Date. All information and portfolio data will be available to each Member Fund on a 24-hour basis via a highly secured internet service (i.e. Intralink).

Independent CFG Audit:

CIBC will contract for an independent annual Audit Report of the CFG operations. The scope of the audit will ensure that CIBC is in compliance with the SAA and other CFG requirements. Each Member Fund will receive a copy of the Audit Report and related Management Report.

Termination Provision:

Failure of CIBC to perform any of the key SAA requirements will result in default and will provide for CFG to immediately replace CIBC. The Member Funds will have the right of control, under the SAA, with respect to a replacement SAA provider based upon a number of factors including servicing capabilities, operational expertise, and knowledge of and commitment to the industry.

CIBC Existing  
Portfolio:

In order to achieve immediate revenue generation, CIBC will make available certain Credit Instruments within their existing portfolio for inclusion into CFG. The intent is to transfer only the highest quality and highest yielding assets into CFG. The group of assets to be transferred will have an underlying credit rating of BBB+ or better. Any clients and/or Credit Instruments that are made available for inclusion into the CFG portfolio will be subject to CFG Credit Policy and Guidelines.

Future Growth: The rating agencies will provide criteria allowing CFG's underwriting capacity to increase in two ways:

- (i) asking each Member Fund to increase its Master LOC and/or
- (ii) adding new Member Funds.

As new Member Funds join, it is anticipated that these funds will take a pro-rata share of existing CFG commitments. Each pension fund shall have the right-of-first refusal on the decision to increase its Master LOC or add a new fund.

Member Funds  
Disclosure:

Similar to the commercial bank market, we will be required to provide on a quarterly basis updated CFG's Summary Description for inclusion in the Official Statements of each financing. Also, under the SAA, CIBC will be required to mail full financial statements on each Member Fund to investors upon request. As disclosure standards evolve, each member fund will be required to meet the highest standard of continuing disclosure requirements, including filing new material information.



**Consortium Financial Group LLC (CFG)**  
**Pro-Forma Fee Income Projections**

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Total Portfolio	\$2.6 Bil	\$4.8 Bil	\$7.7 Bil	\$9.9 Bil	\$12.1 Bil
Net Revenues	\$8.4 Mil	\$15.5 Mil	\$25.2 Mil	\$31.8 Mil	\$38.2 Mil

# **CONSORTIUM FINANCIAL GROUP**

## **CREDIT POLICY**

Dated November 1, 1999

**A. Mission Statement**

To diversify each Member Funds investment portfolio and to maximize fee income generation from public sector transactions consistent with the diligent application of sound credit analysis and judgment while minimizing risk through appropriate legal and time tested structural techniques.

**B. Code of Conduct and Underwriting Standard**

CFG will structure and underwrite credit transactions to a zero loss standard and CIBC, acting as Service Agent to CFG, agrees to be bound by the standards of conduct applicable to a fiduciary of a public-sector pension fund.

**C. Introduction**

The objective of CFG's Credit Policy and Guidelines is to provide a framework with which to measure and control credit risk in order to achieve a highly diversified portfolio of transactions. 'revision and approval by CFG's Member Funds not less than annually on each anniversary of CFG's inception. The municipal market continues to evolve and CFG will need to respond to changing conditions in the marketplace over time.

**D. Credit Approval Policy and Procedures**

All transactions will be subject to the following process in order to be deemed eligible for inclusion in the CFG portfolio.

**Step 1:** CFG staff prepares a Memorandum of Issuance ("MOI") in response to a potential opportunity. CFG staff will be required to ensure that the MOI complies with all aspects of the approved Credit Guidelines.

**Step 2:** Next, a complete and thorough credit analysis of the transaction is performed. If the analysis proves satisfactory by CFG staff, the MOI is presented to two CFG Senior Designees for approval. If approved, the MOI is deemed "CFG Approved" and forwarded to CIBC's Risk Management Group.

**Step 3:** CIBC's Risk Management Group will respond with an approval or decline for their 3% share in the transaction. If CIBC declines, the MOI is rejected and the opportunity is no longer active. If CIBC approves, the credit process moves to Step 4.

**Step 4:** After the MOI is "CFG Approved" and "CIBC Approved", the CFG staff will be required to complete the final stages of due diligence and documentation.

**Step 5:** Final Documentation must be approved by a CFG Senior Designee, with such approval notated on the MOI.

**Step 6:** Once all approvals and signatures are obtained as required in Steps 1–5, the MOI is deemed to be complete and the Credit Instrument is issued.

The MOI will be made available electronically to all Member Funds during every stage of the Credit Approval process. At closing of each transaction, in addition to the final MOI, CFG will provide electronically other pertinent documentation including the Reimbursement Agreement, Trust Indenture, the Remarketing Agreement, Official Statement and a copy of the Credit Instrument. Attached Exhibit A is a sample final MOI.

## ***E. Types of Credit Instruments***

CFG shall provide two types of Credit Instruments:

### **1) Lines of Credit**

These are revocable instruments. These are also referred to as Standby Bond or Note Purchase Agreements. These are designed to provide liquidity (as opposed to credit enhancement) in the event of financial market disruption. The legal obligation to fund under these instruments is **conditional**.

### **2) Letters of Credit**

These are irrevocable instruments used to provide credit and liquidity on variable rate or fixed rate note and bond transactions. The legal obligation to fund under these instruments is **unconditional**.

CFG will not provide direct funded loans.

## ***F. Portfolio Report and Municipal Credit Outlook***

CFG will prepare and distribute to all Member Funds the following reports:

### **1. Portfolio Report**

The Portfolio Report will be posted electronically and be made available on a 24 hour basis. It will provide detailed analysis of CFG's portfolio and its compliance with the Credit Guidelines. It will be in database format allowing Member Funds to query the report and create custom reports as needed. CFG will also be willing to prepare other customized reports on an as needed basis. A draft sample is included as Exhibit B.

### **2. Credit Market Indicator Report (CMI Report)**

The CMI Report will provide the Servicing Agent's assessment of current conditions in the U.S. municipal market including credit and non-credit trends, economic outlook, pricing factors, competition, new forms of security, issuance

volume, and other factors deemed appropriate. The CMI Report will be updated on a quarterly basis.

**G. Exception Category to CFG Guideline**

A 10% Exception Category (based on the current portfolio) is established for exception to CFG Credit Policy Guideline #1. This Exception Category to the Credit Policy Guideline #1 will include non-investment grade transactions.

This Exception Category is intended to be a very small component of the CFG portfolio. It is needed in order to respond to changing market conditions and to take advantage of key opportunities that would not specifically fit into CFG's Credit Policy Guidelines.

**H. Portfolio Liquidity**

CFG shall continue to maintain portfolio liquidity and secondary market capacity as part of CFG's on-going exposure management policies. The ability to close out a Credit Instrument position via participation and/or assignment is an important portfolio management tool. The two most common occurrences under which a sale may be advisable is if CFG sees a deteriorating credit profile or if new, higher fee transactions present themselves at a time when CFG is at or near its credit policy limits. CFG shall maintain standard participation documentation in each transaction to assure the legal standards are in place to effect an exposure selldown. It is anticipated that commercial banks and non-profit endowments will be likely sources of participation capacity. All such participants shall be rated investment grade (BBB) or better by at least one major recognized credit rating agency. For purposes of the Credit Policy Guideline, a major recognized credit rating agency means: Fitch IBCA, Moody's Investors Service, or Standard and Poor's.

**I. Effective Date of Credit Policy Guidelines**

The Credit Policy Guidelines are based on a concept which allows transactions to be included based on an average percentage of the portfolio. Given that fact, the Guidelines will be implemented over a time horizon allowing for initial accumulation of transactions. Each Guideline is effective as follows:

<i>Guideline</i>	<i>Description</i>	<i>Effective Date from CFG Inception</i>
1	Credit Rating	6 months
2	Term of Transaction	Inception
3	Average Maturity	1 year
4	Geographic Distribution	1 year
5	Municipal Sector	6 months
6	Member Fund Limit Per Transaction	Inception
7	Single Name Limit	Inception



# **CONSORTIUM FINANCIAL GROUP**

## **CREDIT POLICY GUIDELINES**

**Dated November 1, 1999**

## GUIDELINE # 1: Credit Rating Guideline

<i>CIBC Risk Rating Code (1)</i>	<i>S&amp;P Short Term Rating Category*</i>	<i>S&amp;P Long Term Rating Category*</i>	<i>CFG Portfolio Credit Rating Guideline</i>
0-1	A-1+	AAA	Not to exceed 100%
1-2	A-1	AA	Not to exceed 100%
2-3	A-2	A	Not to exceed 80%
3-4.5	A-3	BBB	Not to exceed 50%

*\* S&P or an equivalent rating by Moody's or Fitch. See Attached Exhibit C.  
(1) Exhibit C also describes CIBC's internal risk ratings.*

### **Descriptive Commentary**

The municipal market is extremely stable. Very few issuers have experienced rating changes of one whole category or more over a five-year horizon. Even during the recent recessions in the early 1980's and 1990's, the base underlying economic and socio-economic foundations do not fundamentally change the long-term debt paying ability of State and Local Governments. Only over the long-term do these economic and financial trends begin to impact an issuer's rating and therefore, the strength of the debt repayment capacity.

<b>CIBC Risk Management Rating Code</b>	<b>Rating Category Designation *</b>	<b>CFG Ratings Category Target Portfolio</b>
0-1	AAA	Less than 3%
1-2	AA	18 – 22%
2-3	A	30 – 35%
3-4.5	BBB	30 – 35%

*\* S&P or an equivalent rating by Moodys or Fitch. See Attached Exhibit C.*

*\*\* Subject to Exception Category as described in the Credit Policy Section G.*



## GUIDELINE # 2: *Term to Maturity of Credit Instruments*

<i>Term to Maturity</i>	<i>Percentage of CFG Portfolio</i>
$\leq 3$ years	Not to exceed 100%
$> 3$ years but $\leq 5$ years	Not to exceed 75%
$> 5$ years but $\leq 7$ years	Not to exceed 50%
$> 7$ years but $\leq 12$ years	Not to exceed 25%

### *Descriptive Commentary*

CFG will be focused on the short and intermediate term Credit Instrument market. In general, CFG will be structuring transactions such that the seasoned and mature portfolio will fall within the following parameters:

<u><i>Term to Maturity</i></u>	<u><i>Target Range</i></u> <u><i>Percentage of CFG Portfolio</i></u>
$\leq 3$ years	32 – 35%
$> 3$ years but $\leq 5$ years	38 – 40%
$> 5$ years but $\leq 7$ years	15 – 18%
$> 7$ years but $\leq 12$ years	7%

**GUIDELINE # 3: *Portfolio Average Maturity***

<i>Test</i>	<i>Not to Exceed</i>
<b>Weighted Average Maturity</b>	<b>4.5 Years</b>

***Descriptive Commentary***

By the end of the first full year of operation (First Anniversary) of CFG, the weighted average maturity will not to exceed 4.5 years.

According to industry data, although normally issued for 25 to 30 years, the average life of a municipal bond is 12 years. This is due to a number of factors including refunding opportunities, early repayment, debt restructuring, or other factors. This will tend to shorten CFG's portfolio actual average life below the stated weighted average term as presented in these guidelines.

CFG will be able to obtain premium pricing on the long-term Credit Instruments, with the actual maturity, an average, being well under the stated weighted average. This strategy will improve the pricing returns to each Member Fund.

## GUIDELINE # 4: *Geographic Distribution*

<i>Issuer Location</i>	<i>Percentage of CFG Portfolio</i>
<b>California</b>	<b>Not to exceed 30%</b>
<b>New York</b>	<b>Not to exceed 20%</b>
<b>Florida</b>	<b>Not to exceed 20%</b>
<b>New Jersey</b>	<b>Not to exceed 20%</b>
<b>Texas</b>	<b>Not to exceed 20%</b>
<b>Pennsylvania</b>	<b>Not to exceed 20%</b>
<b>Illinois</b>	<b>Not to exceed 20%</b>
<b>Massachusetts</b>	<b>Not to exceed 20%</b>
<b>Michigan</b>	<b>Not to exceed 20%</b>
<b>Ohio</b>	<b>Not to exceed 20%</b>

### **Descriptive Commentary**

CFG's portfolio, on an aggregate dollar total, will be distributed on a parallel basis to municipal issuance across the entire market. Since issuance volume is directly correlated to population, opportunities and hence CFG's portfolio, will be aligned with states having the largest population.

The ten (10) States above have the largest volume and should comprise approximately 55 – 60% of CFG's portfolio as it matures. The list above will be reviewed annually; however, these States have consistently been "top-10" States for at least the last 10 years.

	<u><b>Market Data</b></u>			<b><i>Current CIBC Portfolio</i></b>	<b><i>CFG Target Portfolio</i></b>
	% of Total Long Term Bond Market	Variable Rate Volume*	Annual Variable Debt Issued**		
California	12 – 16 %	12%	\$3,536	27%	25%
New York	12 – 16 %	10%	\$2,518	8%	12%
Florida	5 – 7 %	9%	\$1,082	1%	5%
New Jersey	2 – 4 %	5%	\$284	0%	5%
Texas	3 – 5 %	11%	\$1,766	5%	6%
Pennsylvania	5 – 7 %	14%	\$1,396	8%	7%
Illinois	2 – 4 %	18%	\$1,748	1%	5%
Massachusetts	2 – 4 %	9%	\$662	7%	5%
Michigan	2 – 4 %	8%	\$507	7%	5%
Ohio	2 – 4 %	16%	\$1,246	3%	5%

\* 3 year average as a percentage of Total Volume

\*\* 3 year average in millions

<b>GUIDELINE # 5: <i>Municipal Sector Limit</i></b>
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<i>Sector #</i>	<i>Sector</i>	<i>Percentage of CFG Portfolio</i>
1	General Obligation	Not to Exceed 100%
2	General Fund/ Short Term Cash Flow Notes	Not to Exceed 100%
3	Public Infrastructure, Facilities and Equipment	Not to Exceed 80%
4	<b>Education – State and Local</b>	Not to Exceed 75%
5	Transportation and Highway	Not to Exceed 75%
6	Water and Waste Water	Not to Exceed 75%
7	Airport and Marine Ports	Not to Exceed 75%
8	Municipal Utility Systems	Not to Exceed 50%
9	Solid Waste Facilities/Resource Recovery/Environmental	Not to Exceed 50%
10	Healthcare	Not to Exceed 30%
11	Housing	Not to Exceed 30%
12	Not-for-Profit Organizations	Not to Exceed 30%
13	Student Loan Pool Programs	Not to Exceed 30%
14	Tender Options Programs	Not to Exceed 25%
15	Securitization Programs	Not to Exceed 25%
16	Industrial Development	Not to Exceed 25%
17	Education – Private	Not to Exceed 25%
18	Stadiums/Arenas	Not to Exceed 25%
19	Unclassified Sector	Not to Exceed 20%

**Descriptive Commentary**

All of the Issuers within the CFG portfolio will be from one of the outlined governmental and public sectors that comprise the U.S. municipal market. This will include the non-profit 501(c)(3) institutions.

**GUIDELINE # 6: *Member Fund Limit per Transaction***

	<i>Amount</i>
<b>Member Fund</b>	<b>\$250 Million</b>

***Descriptive Commentary***

Initially, CFG will set a \$250.0 million single risk limit per transactions for each Member Fund.

By virtue of CFG's member structure, CFG will be able to enhance or provide liquidity on very large transactions. Given the assumption that three to four Member Funds are the initial sponsors, CFG will be able to underwrite up to \$750 million to \$1.0 Billion in a single financing provided all other Credit Guidelines are complied with.

## **GUIDELINE # 7: *Single Name Issuer Limit***

<i>Single Name Issuer Rating Category</i>	<i>Limit</i>
<b>AAA rated</b>	<b>\$1.0 Billion</b>
<b>AA rated</b>	<b>\$750 Million</b>
<b>A rated</b>	<b>\$500 Million</b>
<b>≤ BBB+ rated</b>	<b>\$250 Million</b>

### **Descriptive Commentary**

The Single Name Limits established under this guideline are based, in part, upon the initial Master Letters of Credit that each Member Fund provides. These limit the amount of transactions CFG will be able to underwrite. It is intended that the Single Name Limits will be revised upward as Member Funds are added over time. Again, because return is inversely correlated with the underlying credit rating, we would anticipate having the majority of CFG's exposure in the "A" and "BBB" categories.

PROPOSED  
RESOLUTION OF THE  
CALIFORNIA STATE TEACHERS' RETIREMENT BOARD  
INVESTMENT COMMITTEE

SUBJECT: Consortium Financial Group (CFG)

Resolution No. \_\_\_\_\_

WHEREAS, the Investment Committee of the California State Teachers' Retirement Board is responsible for recommending to the Board, investment policy and overall investment strategy; and

WHEREAS, the Investment Committee has previously amended the Credit Enhancement Policies to include school districts and other employing agencies in the existing program subject to the 25% Internal Revenue Code Safe Harbor provisions; and

WHEREAS, the Investment Committee has received and reviewed the proposed Consortium Financial Group Term Sheet, projections, Credit Policy and Credit Policy Guidelines, and has heard an oral presentation by representatives of Canadian Imperial Bank of Commerce (CIBC);

Therefore be it

RESOLVED, that the Investment Committee of the California State Teachers' Retirement Board approves the concept of an externally managed national credit enhancement program that will serve to complement the existing internally managed Credit Enhancement Program; and directs CalSTRS Staff to continue discussions regarding Consortium Financial Group (CFG) business and legal terms.

Adopted by:  
Investment Committee

On \_\_\_\_\_

\_\_\_\_\_  
James D. Mosman  
Chief Executive Officer